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DECEMBER 7, 1987

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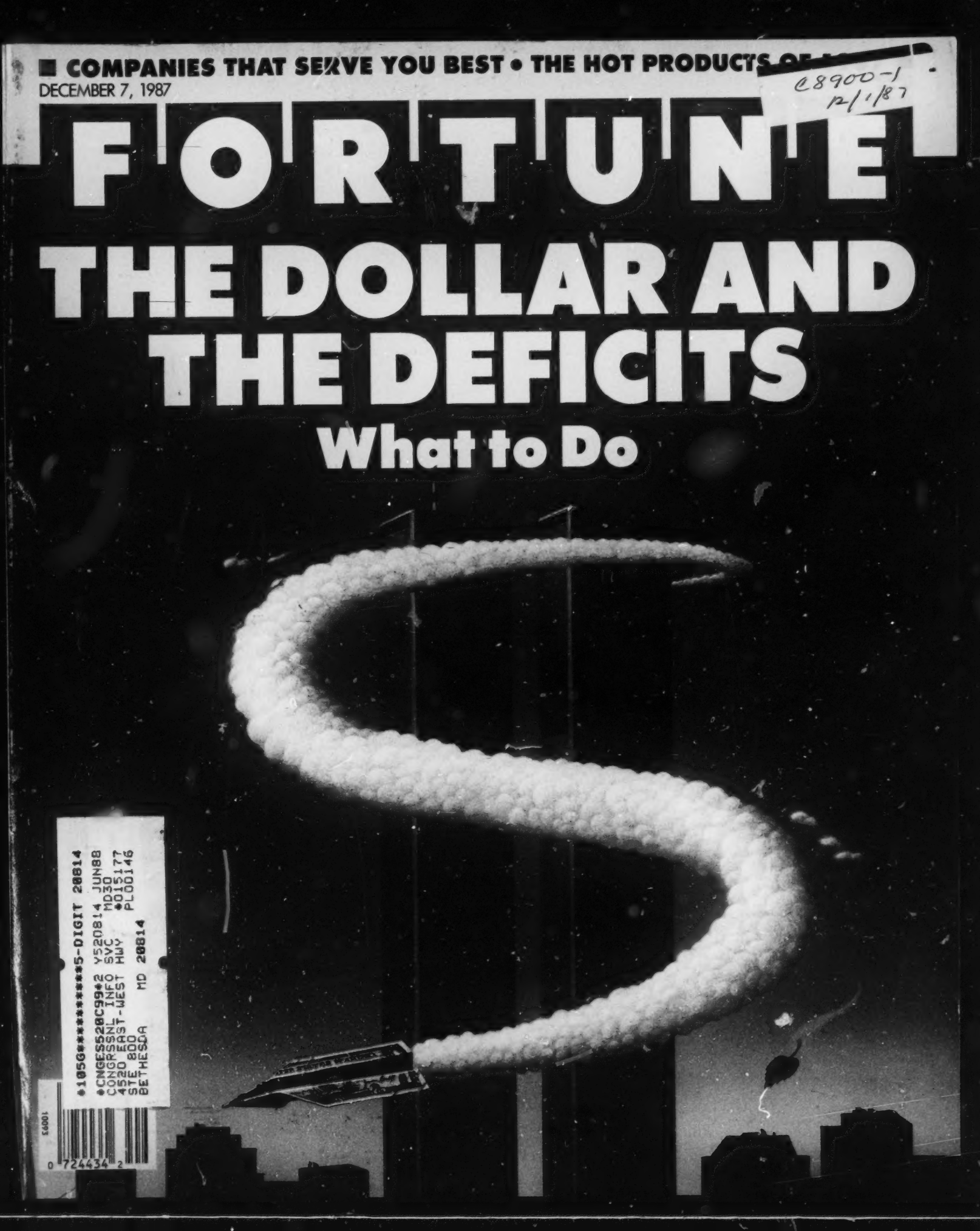
FORTUNE

THE DOLLAR AND THE DEFICITS

What to Do



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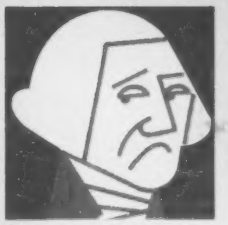
FORTUNE



"Here's the Treasury Department leading the easy-money parade! It scares the daylights out of the whole world."
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"We took a good look at the American system and adopted many of its features."
PAGE 53

"I'm a very bad customer, always looking at the jobs people do and the way they do them."
PAGE 98

"It's a killer condom."
PAGE 120

"I haven't had any pangs yet over loss of power and prestige and perquisites."
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"The propensity to gamble is always increased by a large prize vs. a small entry fee, no matter how poor the true odds."
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THE EDITOR'S DESK

THIS IS a love letter. It is written for, and about, a young lady named Mary. Young because, although she has worked for our company for almost four decades, she has a contagious vitality that infuses the whole staff. Some people never age. Alas, young Mary Johnston has chosen to retire after 32 years as FORTUNE's chief of reporters.

Her title hardly suggests all her roles. She has been the guardian of this magazine's standards of accuracy, as well as the staff's chief mentor, confidante, confessor, and model for civilized behavior. When confronted with a particularly nettlesome problem, seven managing editors and hundreds of others at FORTUNE over the years have had the same instinctive reaction: "Ask Mary." My eminent predecessor, Bill Rukeyser, says, "Mary never took any guff from the editors." Another former managing editor, Louis Banks, calls her "straight shooting, straight talking, and morally tough."

"Mary's children" toast Johnston (center) with Benjamin (lower right) in New York and in . . .

Chicago . . . *Los Angeles . . .* *Tokyo . . .* *Paris . . .* *and London.*

That is an apt description for an elegant Texan who is a born reporter. Mary graduated from Rice University (which she later served as a member of its board of governors) and spent six years covering the courthouse and other beats for the Houston *Post*. After traveling the world for a year and writing articles for the *Post* and the *Christian Science Monitor* from such countries as Iran and Poland, she joined our sister magazine, *Time*, in 1949 and two years later moved to FORTUNE. She became chief of our large reporting staff in 1955 and was named to the Board of Editors a year later.

The ability to find and hire exceptional people is Mary's special genius. Her first hire was Carol Loomis, then a recent graduate of the University of Missouri School of Journalism and now widely acclaimed as one of the nation's best financial writers. In all, she has hired 62 members of our current staff, most of whom are shown in the photos above. They include assistant managing editor Ann Morrison and nine other members of the Board of Editors, as well as our representatives in Los Angeles, Chicago, Tokyo, Paris, and London. They also conspicuously include Mary's superlative deputy for 15 years, Evelyn Benjamin, who succeeds her as chief.

Mary could spot a terrific talent at 60 feet. She has always been willing to interview any serious applicant and seek far more than formal credentials. Mary looked for curiosity, humor, a willingness to ask any question without embarrassment. She wanted people who weren't frightened by numbers, but that didn't stop her from hiring philosophy and art history majors (she found that many of them made the best reporters). She also hired lawyers, MBAs, Ph.D.s—and some who had no degrees at all. After an interview, she liked to follow an applicant to the elevator, to see how he or she walked. "The way people walk," says Mary, "tells a lot about their attitude and confidence."

Another recent retiree, former Time Inc. editor-in-chief Henry Grunwald, says this: "Mary has given more to FORTUNE than almost anyone I can think of." She leaves her legacy on the pages of this magazine and in the form of all those staff members, whom she calls "my children." Since this is the kind of place where people like to stay for many years, Mary's children will be here to practice her lessons for quite a while—well into the 21st century.

Marshall Loeb

MANAGING EDITOR

JOHN ABBOTT (TOP), GWENDOLEN CATES, MICHAEL SALAS, CAROLINE PARSONS, PIERRE PERRIN–SYGMA, IAN BRADSHAW (BOTTOM, LEFT TO RIGHT)

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TRYING TIMES FOR JUNK BONDS

The biggest and best have recovered from their Black Monday blues. But investors are still leery of the junkiest junk and of bonds to finance leveraged buyouts. ■ *by Ford S. Worthy*

A QUICK READING of the indexes that junk bond dealers compile to track the performance of those high-risk, high-yield securities leads to only one conclusion: Though pummeled along with stocks in the October crash, junk bonds have bounced back, just as they did shortly after the Ivan Boesky scandal roiled the junk market a year ago. By early November, Drexel Burnham Lambert's index of 110 junk bonds showed that prices were almost back to their pre-crash levels.

What Drexel's index, which is made up of the largest issues in the less-than-investment-grade universe, does not show is that important segments of the junk market have not rebounded—and may never. The prices of some bonds sold to finance leveraged buyouts fell like bricks and show no signs of turning into hot-air balloons. A pending $1.5-billion junk bond offering for the leveraged buyout of Southland Corp. fell apart in early November, and other LBOs could be in trouble (see following story). Another important slice of the junk market is made up of bonds issued by thinly capitalized, small to medium-size companies. Many of these bonds were still down 10% by mid-November, and some were down much more. For now at least, it appears these debt-heavy companies will find it harder, and more expensive, to raise money.

The sudden aversion to the most tarnished junk reflects three post-crash realizations. The stock market collapse immediately devalued the assets of all companies—including the assets that some junk bond issuers had counted on selling to pay down debt. The collapse in stock prices also makes it less likely that companies will be able to pay off debt by selling new equity, as many junk issuers have done over the past two years. And a slowdown in the economy, which is more likely after the crash, would shrink the cash flows of plenty of junk issuers that have little maneuvering room even in a growing economy.

Mutual fund managers, who control some $31 billion in junk bonds, according to Lipper Analytical Services, led the rush for the exits on Black Monday. The managers feared that their shareholders would bail out en masse, so they scrambled to sell bonds in order to be ready to redeem shares. But for most, the stampede never came. The shareholders apparently were less rattled by the crash than the fund managers.

DEBORAH FEINGOLD

Fred Joseph *of Drexel Burnham is still a junk fan.*

All investors who sold discovered a painful truth about the junk market: The bonds they most wished to be rid of were the hardest to unload. Buyers especially shunned the weakest of the small credits—issues with less than $100 million in bonds outstanding, a category that comprises perhaps 15% of the total junk market. Says Melvin Mogel, who runs U.S. Life's $100-million junk bond portfolio: "Some of these names trade by appointment only." When the crash came, many brokers in the junk market weren't making appointments.

One broker who apparently was buying, however, was Drexel, which vaulted into the investment banking big leagues by virtually creating the junk bond market and is the largest dealer of all. Money managers say that Drexel had pulled back from the junk market several months before the crash, but moved in again after prices tumbled. Why had Drexel pulled back? Says Ken Urbaszewski, a mutual fund manager at Kemper Financial Services: "I think Drexel correctly foresaw that low-grade bonds would get cheaper."

Drexel itself speaks only in the vaguest ways about what it has been doing. Of reports that it had cut its bond inventories, Larry Post, a senior vice president in Drexel's high-yield group, offers this: "Maybe we sensed that the market had a little correcting to do." And has Drexel been a big buyer recently? "We have $1.25 billion in excess capital now, so if we think the market is cheap—as we do now—we can jump in with both feet if we want to." Drexel Chief Executive Fred Joseph maintains that the junk market is just fine. "The overall high-yield market is in good health, with trading volume the strongest it's been in two years," he says.

The odds are that Drexel's inventory

REPORTER ASSOCIATES *Rosalind Klein Berlin and Sarah Smith*

doesn't include many bonds issued by the 24 companies that FORTUNE identified in a special study last March as particularly vulnerable to default (see table). Houlihan Lokey Howard & Zukin, a Los Angeles firm that helped prepare that list, estimates that these "atomic" bonds dropped an average of 8% in October. The average total return (including interest payments) since February has been minus 10%. Five of the atomics have defaulted on junk bonds with a face value of approximately $300 million. Bonds issued by ten others recently traded at less than half face value—close to what a bond typically trades for after defaulting.

Many investors in junk see the October meltdown not as a signal to sell but a beckoning to buy. With interest rates on junk rising while the rates on government bonds have been falling, the spread between the two has widened to near-record levels. Devotees of junk say the large spread guarantees that well-diversified investments in high-yield bonds should outperform government bonds even in the event that the most extreme predictions of defaults come true.

But even the most avid junk collectors are becoming much more selective. Fred Carr, chief executive of First Executive Corp., a West Coast insurance company that has invested heavily in high-yield bonds, says he has invested in only 15% of all new offerings this year—down significantly from prior years. Carr and most other big players in the market are still hungry for junk bonds. But they want to make sure that those promised high yields are more than just promises. F

Atomic Bonds Revisited

In the nine months since FORTUNE *identified these 24 junk bond issuers as "atomic," or especially vulnerable to default, five have indeed gone critical. Most of the others still look hazardous.*

COMPANY	PRINCIPAL AMOUNT in millions	DESCRIPTION	PRICE % of face value 2/1/87	10/1/87	11/2/87	STATUS
Alleco	13.0	10.0% bond due '97[1]	82	63	68	
American Healthcare Management	80.0	15% bond due '04	84	34	27	In default
Cannon Group	41.4	12.375% note due '94	74	28	19	
Care Enterprises	16.0	16% note due '94[1]	109	89	85	
Compact Video	80.0	12.75% bond due '96[1]	100	92	80	
Consolidated Oil & Gas	2.2	12% bond due '95	43	64	66	
Consul Restaurant	5.8	13% bond due '92[1,2,5]	41	72	65	
Lifestyle Restaurants	4.7	13% bond due '97[1,2,5]	52	85	74	
Michigan General	110.0	10.75% bond due '98[1]	56	35	29	In default
Pay 'N Save	145.0	7.125% bond due '06[2]	60	64	49	
Pennsylvania Engineering	6.1	5% bond due '93[1,2]	30	25	20	
Penril	18.0	10.875% note due '93[1]	86	47	43	In default
Po Folks	15.8	11.5% bond due '04[1,2]	62	45	43	
Pope Evans & Robbins	35.0	13.5% bond due '02[1]	85	62	61	
Preway	50.0	13.875% bond due '99[1]	77	53	49	
Quanex	96.1	15.25% bond due '99[4]	95	105	95	
Reading & Bates	60.0	8% bond due '95[1,2,3]	28	39	39	
Spendthrift Farm	30.0	12.5% bond due '94[1]	21	16	15	In default
Texas International	34.8	10% note due '93	90	90	88	
Thousand Trails	12.5	14.625% note due '92	57	52	44	
Wean	16.8	5.50% bond due '93[1,2]	38	48	44	
Western Union	22.9	10.75% bond due '97[1]	62	47	41	
Westworld Community Healthcare	30.0	14.5% note due '95[1]	71	8	11	In default
Winners	25.0	8.25% bond due '03[1,2]	48	42	30	

Sources: Houlihan, Lokey, Howard & Zukin and Merrill Lynch
1 Subordinate 2 Convertible 3 Eurobond 4 Mortgage bond 5 Acquired by another company

LBOs ARE TAKING THEIR LUMPS

Leveraged buyout companies are now facing pinched cash flows, reduced prices for assets, and a suddenly cautious junk bond buyer. Were their critics right after all? ■ *by Carol J. Loomis*

IN THE LAND of leveraged buyouts, Black Monday brought down the curtain on Act 1 (light drama, with touches of comedy) and raised it on Act 2 (heavy, heavy). An audience generally skeptical of LBOs is waiting for the denouement. The critics have long complained that these deals serve little economic purpose beyond enriching management, underwriters, and lenders, and that the companies have become so prodigiously leveraged with debt that they could not withstand a financial storm. The principals of the LBOs have responded by chanting their mantra, "Cash flow, cash flow," and flashing deal-generated profits as prodigious as the debt. But it's crunch time now.

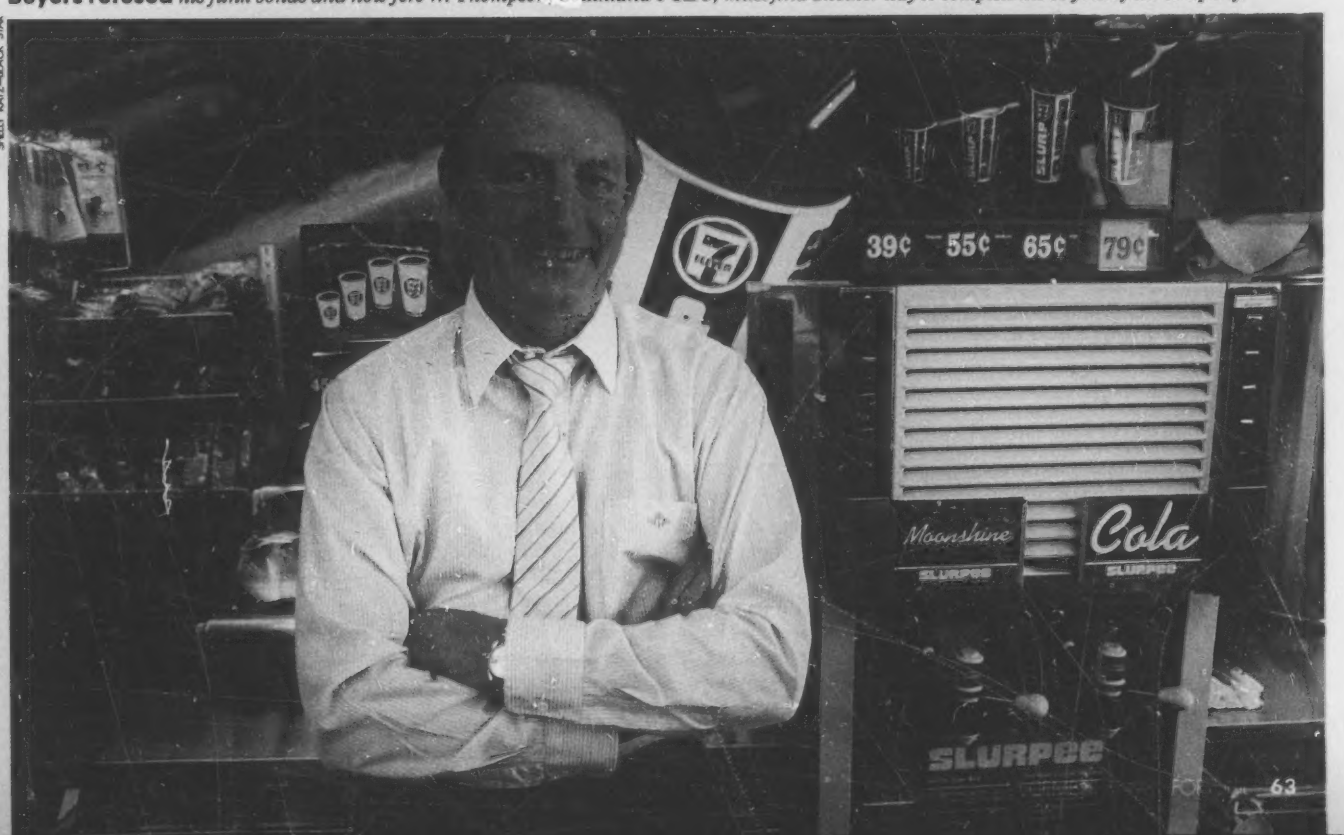
The stock market crash, in its countless reverberations, threatens the cash flow of the LBOs. Should the crash be a harbinger of a recession or a slowdown in economic growth, the operating profits that the LBOs need to pay interest on their debt would be cut. More immediately, the crash has impaired the ability of LBOs to sell off divisions and raise the large hunks of money typically required for debt repayments. What the investment banking trade calls "exit strategies"—the routes that the sponsors of LBOs use to cash out their investments—are also a problem. One exit is a public offering, of which not too many are likely to be made soon. Another is a refinancing that might require the company to issue junk bonds.

Alas, since the third Monday in October, fears of a recession and doubts about the creditworthiness of many leveraged companies have sent the junk bond market into a state of shock (see previous story). In mid-November, one concern that was trying to complete an LBO, Southland Corp., owner of the 7-Eleven chain of convenience stores, had to scuttle its plan to issue $1.5 billion in junk bonds. The bonds could not be sold, even at rates of 18%.

Southland is worth examining closely, for it illustrates the intricate dangers of trying to pull off an LBO at this particular moment. As in most LBOs, Southland was trying to go

Buyers refused *his junk bonds and now Jere W. Thompson, Southland's CEO, must find another way to complete his buyout of the company.*

SHELLY KATZ—BLACK STAR



An Equity-Light, Debt-Laden Dozen Deals

Some LBOs have paid off a portion of their debt, as this table of megadeals from the last two years shows. Beatrice and Lear Siegler were among those able to sell assets before the market went sour and thus pare their debt. More recent buyouts are still loaded up. Four of these companies actually have negative net worth. The leveraged recaps that Harcourt and Holiday went through had the effect of obliterating their equity and then some.

COMPANY	TYPE OF DEAL	DATE BEGUN	PRICE (millions)	CURRENT CAPITALIZATION* Debt (millions)	Equity	STATUS REPORT
Beatrice	LBO by Kohlberg Kravis Roberts	4/86	$6,200	$3,900	−$126	A rousing success. But the crash could knock down the price of the company's domestic food business, now up for sale.
Safeway	LBO by Kohlberg Kravis Roberts	8/86	$4,900	$3,600	−$18	Plans that the company had to go public soon may now gather some dust. Capital spending has been cut severely.
Southland	LBO by Thompson family	7/87	$4,900	$4,700**	$213**	The company could not sell junk bonds to complete its deal. The next step is uncertain.
Borg-Warner	LBO by Merrill Lynch Capital Partners	4/87	$4,400	$3,700	$194	The company's bonds slipped recently as investors brooded about a $2-billion debt repayment due in 1988.
Owens-Illinois	LBO by Kohlberg Kravis Roberts	2/87	$3,700	$4,400	$180	The company is trying to pile leverage on leverage by buying Brockway, but antitrust approval is needed.
R.H. Macy	LBO by management	7/86	$3,700	$2,800	$264	A sluggish economy tends to hit retailers hard. The company is holding down hiring and battening the hatches.
Jim Walter	LBO by Kohlberg Kravis Roberts	8/87	$3,400	$3,300**	$150**	A pending deal, for which Drexel Burnham is urgently peddling junk bonds. The prognosis is unclear.
Burlington Industries	LBO by Morgan Stanley	5/87	$2,800	$2,900**	$125**	Around $900 million in assets must be sold. The first plant to go was offloaded to a pleased competitor.
Harcourt Brace Jovanovich	Leveraged recapitalization	5/87	$2,600	$2,900**	−$1,160**	The company paid a big price to do its deal, but is banking on a strong cash flow from operations and major cost cutting.
Holiday	Leveraged recapitalization	4/87	$2,600	$2,800	−$777	A program of selling real estate assets is about 80% complete, but getting rid of the rest may be slow going.
Lear Siegler	LBO by Forstmann Little	12/86	$2,100	$725	$200	A rarity: a deal that didn't use junk bonds. After $1.2 billion in asset sales, the company is largely down to "keepers."
Supermarkets General	LBO by Merrill Lynch Capital Partners	4/87	$2,000	$1,900**	$199**	Traditionally a well-run market leader, it needs to cut capital spending as an LBO and is taking the risk of doing so.

*Latest figures published. **Pro forma figures.

private using a mountain of borrowed money to buy out the public shareholders. In such ventures, management and LBO sponsors—a Kohlberg Kravis Roberts, say—normally contribute a sliver of equity capital, enough to make up about 10% of total capitalization. The rest comes from bank loans and subordinated debt. Meanwhile, a vast collection of midwives, including investment bankers, commercial bankers, lawyers, and sometimes the sponsors themselves, collect enormous fees for aiding this exotic birth.

It ordinarily takes two steps to get an LBO out of the womb. In the first, the sponsors make a tender offer for perhaps 70% of the company's outstanding stock. At Southland, a tender for two-thirds of the company took place last July at $77 a share, a 40% premium over the $55 the shares were trading at before the buyout was announced. Making the tender and sponsoring the buyout was a shell company called JT Acquisition, formed by the Thompson family, whose sire (Joe) founded Southland. JT Acquisition financed the tender with $2 billion borrowed from a group of banks and a $600-million "bridge loan" from investment bankers Goldman Sachs and Salomon Brothers.

JT ACQUISITION then revved up for the next step that included securing permanent financing, buying the remaining Southland shares, and merging JT Acquisition with Southland. In this part of the deal, the shareholders still holding the common were to get about $61 in cash plus preferred shares in the new, private Southland. In other words, the old shareholders were to supply some equity capital to help buy themselves out. The company expected to issue $1.5 billion in junk bonds to pay the $61 a share and to pay off the bridge loan.

As a private company, Southland's capitalization was supposed to be about $4.9 billion. Interest charges were expected to run to $530 million in 1988, causing Southland a $225-million loss for the year. Sounds grim, but that's ordinary stuff for LBOs. Unfortunately, the Thompsons were trying to sell the junk bonds just as the stock market went through the most *extra*ordinary decline ever. Prospective junk buyers withdrew in alarm, suddenly apprehensive about every aspect of the deal, including Southland's ability to meet its interest payments and to sell about $1.1 billion in assets to help out cash flow.

In the end, there was no acquisition of the remaining shares and, for now at least, no merger. The banks and the two investment

REPORTER ASSOCIATE *Terence P. Paré*

bankers are sitting with $2.6 billion in loans made to JT Acquisition, which now owns 70% of Southland but does not as yet have control of the company's assets and earning power with which to service its debt. The Southland saga is not over and the players are making urgent efforts to see that the show goes on. But critics of LBOs and of the huge fees they generate for Wall Street are chortling to see Goldman and Salomon trapped in their $600 million bridge loan. Caught with them are a few of their institutional customers on whom the two firms had laid off part of the risk. Around Salomon, these folk are known as "the bridge club." The hand they are holding now is none too good.

Southland's troubles and those of some other recent deals stem partly from the bull market that prevailed earlier this year. Sponsors were tendering for shares at premiums to stock prices that were already astronomical. The $77 that the Thompson family offered for Southland stock last summer was nearly 20 times 1986 earnings, a steep multiple for a company that had not been showing a lot of growth. In April, Supermarkets General, owner of the Pathmark chain, went private by paying stockholders 29 times earnings; Burlington Industries, the textile company, topped that in May with a price that was 39 times earnings.

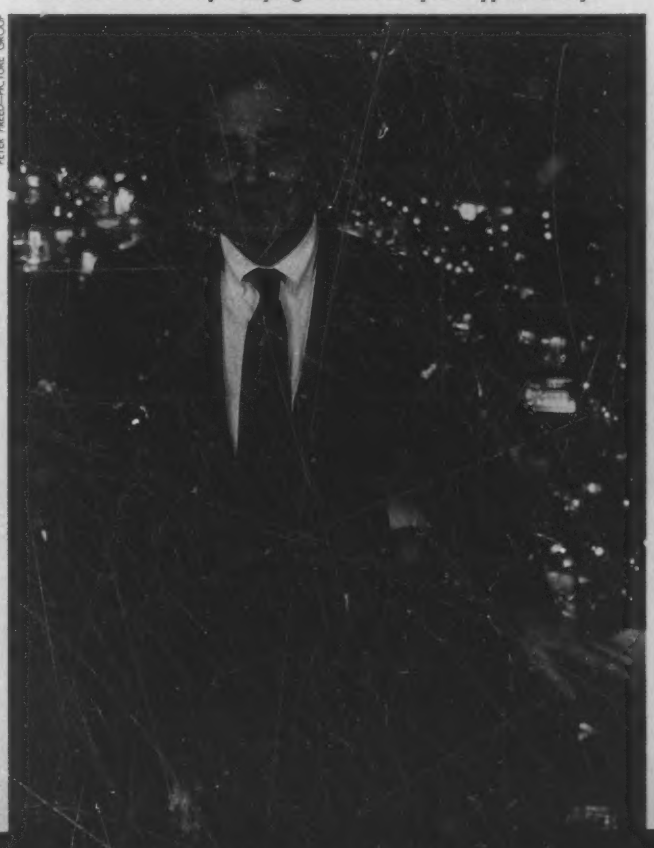
LBO sponsors still thought the deals worth doing because they believed enough cash could be squeezed out of operations and sales of assets to service the debt. Nonetheless, prices got so high this year that even some of the principals cried folly. One absurd series of events occurred at Jim Walter, the Florida housing and construction company. Kohlberg Kravis Roberts, the biggest LBO sponsor, and Paine Webber, a relative newcomer to the game, went at each other in a bidding war to take Jim Walter private.

WHEN Paine Webber pushed its bid up to $69 a share, or 16 times earnings, Jim Walter's management publicly protested that the price would saddle the company with more debt than it could handle. Jim Walter's board agreed and accepted KKR's lower bid of $60 in August. The sight of directors rejecting a higher offer for a lower one must have thrilled shareholders. But as it happens, the buyout may not be completed anyway. KKR was selling junk bonds to finance the purchase when the stock market crashed and the high-yield buyers backed off. Like the Southland deal, this one is also in jeopardy.

No big LBO completely escaped the effects of Black Monday—not even Beatrice, a highly successful buyout and at $6.2 billion the biggest of the bunch (see table). Donald Kelly, the deal magician who is Beatrice's chairman, hawked most of its assets months ago when stock and deal prices were still levitating, and has so far negotiated sales of about $6 billion. He has yet to sell the crown jewel, the U.S. food business, including Hunt-Wesson, Tropicana, and Swift-Ekrich. Only a few months ago there was speculation that Kelly could peddle these goods for as much as $4 billion, a feat that would raise total profits on the Beatrice deal to roughly that amount. But today, such logical buyers as Ralston, Heinz, and Pillsbury are selling 25% to 35% below their 1987 highs. Having been marked down themselves, they will surely shave any bids they make for other operations. No telling now how many rocks the crown jewel will bring.

Whatever Kelly garners from the sale will be dessert, but many other LBOs are still trying their teeth on the first course. Burlington Industries went private this year, in an LBO sponsored by the Morgan Stanley investment banking firm, to escape raider Asher Edelman and Dominion Textile of Montreal, a Burlington competitor. A large part of Burlington's $2.9 billion in debt comes due swiftly: $650 million by next June, another $250 million a year later. Morgan Stanley proposes to meet those commitments by

Finkelstein of Macy *is hoping his LBO escapes shoppers' slump.*



PETER FRIED—PICTURE GROUP

Jovanovich of Harcourt *is thinking debt service, not charity.*

WALT JOHNSON—PICTURE GROUP

selling $900 million in Burlington assets.

But this deal closed officially only in early October, and the financial world began to question whether Burlington and Morgan Stanley could find buyers. An answer came in early November, when the company announced that its most modern denim plant would be sold for $205 million. The buyer? None other than that Witch of the North, Dominion Textile. Neither Morgan Stanley nor Burlington relished dealing with this enemy. But Morgan Stanley liked the price and, besides, thought that Burlington's bondholders would welcome proof that an asset sale was still possible.

ANOTHER high-wire act is Borg-Warner, a deal engineered by Merrill Lynch Capital Partners last spring. Borg-Warner has $3.7 billion in debt, of which $2 billion comes due in 1988. The company has talked at times of refinancing its huge chemical division. But such a scheme would require a healthier junk bond market than now exists. In the weeks after Black Monday, that $2 billion appeared to be weighing on the minds of bond investors and Borg-Warner's 12.75% junk bonds slid from around 93 to 84.

At some price, Borg-Warner, Burlington, and other LBOs will unload assets. Their creditors will see to that. But they will also have to look to operating earnings to make up for any cash shortfall from the sale of assets. That means the companies will be bearing down with new ferocity on cost-cutting programs they already have in place.

Harcourt Brace Jovanovich, the publisher that wiped out its equity in a leveraged recapitalization to evade British publisher Robert Maxwell this year, is preparing to make the ultimate sacrifice. Chairman William Jovanovich has decided to sell the company's airplanes. *Grant's Interest Rate Observer* reported that one of its readers asked a rude question at a recent analysts' meeting: "If you need the planes, why are you selling them? If you don't need them, why did you buy them?" Harcourt's answer was not totally to the point. But an adviser to the company says that in the midst of cost cutting, it is necessary for management to show that it too is tightening its belt. Among the belts getting attention are philanthropic contributions: Harcourt is canceling them all at least through 1988.

The belt brigade is also at work at R.H. Macy, a 1986 LBO. Says a manager in Macy's New York headquarters: "We had been running especially lean around here since we went private. But the minute the stock market did what it did, things really went on hold. Budgets are looking supertight. The message is, 'Use your pencils down to the nub.' There used to be rumors here about the company going public pretty soon. I guess we've heard the end of that for a while."

And that's the way it is at one of the more flourishing LBOs. Macy's has just concluded what its chairman, Edward S. Finkelstein, calls "a very good year." Definition? After interest charges of $500 million on $3 billion in debt, the company lost only $14 million, instead of the $63 million it forecast when the buyout was done. In LBO land, such are the yardsticks used to measure progress.

Capital spending would be falling under the ax in today's post-crash environment had not the typical LBO, as a first order of business, already shredded expenditures in order to beef up cash flow. Usually the shredding has been accompanied by explanations that the munificent spending of the past will carry the company through the future. Sponsors of LBOs tend to define the future as the number of years it will take them to exit this deal, at which point other poor souls will have to worry about making capital improvements.

In the nine months ended in August, Safeway, a 1986 LBO, spent $160 million on new stores and capital improvements, less than half the amount it spent in the same period last year as a public company. Supermarkets General, whose stores have always been exceptionally well run, spent $160 million in fiscal 1986 and expected to spend $285 million in 1991. Merrill Lynch Capital Partners, which took the company private this year and now controls it, has cut the forecast for 1991 to $165 million. It remains to be seen what happens to a business that must invest heavily in new stores and modernization, or run the risk of losing out to competitors who are spending freely.

LBO sponsors are now more likely to be around long enough to discover how their strategies turn out. Many of the exits are boarded up for the moment. Robert Mancuso, 40, one of the seven Merrill Lynchers who sit on the Supermarkets General board, believes the world has changed radically. He recalls fondly how Merrill Lynch took Denny's, the restaurant chain, private and then sold it off within a space of two years. But, says Mancuso: "The words 'long term' have been redefined as a result of October 19. The long term may be five to seven years now instead of two." Traditional thinkers who cling to the notion that long term might even exceed seven years will not find in that statement much evidence of radical change. F

MICHAEL L. ABRAMSON—WOODFIN CAMP

Beatrice's Don Kelly *still has his crown jewel to sell.*

STEVEN RUBIN—TIME-LIFE PHOTO

KKR's Henry Kravis *has one buyout deal he's not grinning about—Jim Walter.*

MANAGING

COMPANIES THAT SERVE YOU BEST

Customer coddling is the hot new competitive weapon. As these champs show, providing great service is more difficult, costly—and lucrative—than most managers realize. ■ *by Bro Uttal*

WHEN David Robinson, a New York art dealer, failed to pay his American Express bill for September, American Express called to find out why. "Well," Robinson began, "I just sent you $800. The other $5,372 is for rugs I bought during the summer in Marmaris, on the coast of Turkey. But now I've had them appraised, and they're worth less than half what I paid. The appraisers are afraid of lawsuits and don't want to certify their estimates. What do I do?"

The voice at the other end of the line was calm and kind. "I'll note the dispute in your file. Just write us a letter and summarize the appraisers' estimates." No suspicious questions, no pressure for immediate payment, just an offer to help Robinson solve a problem on the other side of the world. Until the conflict is resolved, American Express isn't demanding the disputed amount.

To a lot of executives that sounds like a crazy way to run a business. But far from costing money, such extraordinary customer service helps American Express earn the fattest gross profit margins in the credit card business. That lesson is sinking in on a growing number of managers. As global competition intensifies and companies around the world invade each other's markets, cost and quality differences among all sorts of goods and services are shrinking. The company that coddles customers best has a competitive edge.

Last summer the Gallup Organization polled senior executives at 615 companies on the importance of eight different factors over the next three years. The winner by a mile: service quality, picked by 48%, well ahead of productivity and government regulation. Remarkably, even executives who turn out goods, not services, said that offering their customers better service will be nearly as important as making higher-quality products.

This new concern with service comes none too soon for most consumers. They're fed up. The Yankelovich Monitor, an annual survey of 2,500 consumers that focuses on social trends, reports that among seven service industries, only supermarkets rose in perceived quality in recent years. Restaurants, hotels, and department stores stagnated, while airlines, banks, and cable TV operators dropped. Technical Assistance Research Programs Institute of Washington, D.C., which has studied complainers for nearly a decade, finds that the service operations of many companies are fielding over twice as many complaints today as they did in the 1970s. Buyers, whether consumers or corporations, are demanding more of sellers and too often aren't getting it.

HANS NEEMAN

New bottoms for old *is a service L.L. Bean offers at cost to owners of its rugged Maine hunting shoes. Repair charge: $24.*

Yet the rewards of giving superlative service have never been clearer. In a gargantuan historical study, the Strategic Planning Institute of Cambridge, Massachusetts, has analyzed the performance of some 2,600 businesses over the past 15 years. Awkwardly named the Profit Impact of Market Strategy, or PIMS, this research shows that financial performance is tied directly to the perceived quality of a company's goods and services. By almost any measure—market share, return on investment, asset turnover—businesses that offer higher quality come out on top. Among the most powerful tools for shaping perceptions of overall quality, the PIMS study finds, is customer service.

Unfortunately, rendering superior service is often a frustrating task. Service experts are fond of pointing out that unlike products, services can't be made in a factory and stored in inventory; they are consumed at the moment of production, and whoever delivers the service, from telephone operators to washing machine repairmen, will do more than any management system can to determine quality. In short, customer service seems depressingly uncontrollable, especially in decentralized, "high contact" industries like the hotel business, where dozens of employees deal with customers. Even companies that shine at service can't offer simple formulas. "A lot of people have fancy things to say about customer service, including me," says Leon Gorman, president of L.L. Bean, the Freeport, Maine, mail-order house that leads its industry in quality of service. "But it's just a day-in, day-out, ongoing, never-ending, unremitting, persevering, compassionate type of activity."

Nonetheless, the masters of cus-

R. IAN LLOYD

"Singapore girls," *future flight attendants for Singapore Airlines, take a beauty class that includes lessons in applying makeup.*

tomer service—many of them listed in the table overleaf—didn't attain that status by accident, and a close look at them reveals strong similarities. They make outlandish efforts to hire only the right people, to train and motivate them, and to give them the authority necessary to serve customers well. They invest earlier and much more heavily than their competitors in technology to support customer service. They keep an especially sharp eye on the competition. And they constantly ask customers to rate the quality of service they have received.

Few organizations combine the elements as well as American Express's charge card operation. The basic card service is similar to that offered by any number of others. Yet American Express customers, both cardholders and businesses that accept the card, are willing to pay a hefty premium over the rates levied by, say, the banks that issue Visa cards. The reason is clear, says Spencer Nilson, who writes a credit card industry newsletter and often lambastes American Express: "There's no getting around the fact that American Express's service is far and away the best in the industry."

THAT IS THE RESULT of what may be the world's most elaborate system for tracking service quality. Despite a strong tradition of excellent service, American Express slipped in the early 1970s. Complaints surged as the card operation expanded too quickly overseas, with too little investment. So James D. Robinson III, chairman of American Express, asked the 12 departments responsible for card operations to develop standards for their own performance and to measure their achievement.

Ray Larkin, then a senior vice president charged with putting the measurement system into practice, soon discovered the system was no good. "Each department was doing great according to its own standards," he says, "but service wasn't improving." American Express called in McKinsey & Co. Instead of controlling quality department by department, the consultants suggested measuring the impact of all the departments' actions on customers. Today that system, called the service tracking report, measures the card operation's success in processing new applications for cards within 15 days, replacing lost or stolen cards in one day, sending out bills that are completely accurate, and performing over 100 other tasks. Every month Robinson and other executives scrutinize how well operations in all parts of the world have lived up to the standards, and ev-

REPORTER ASSOCIATES *Edward C. Baig and Cynthia Hutton*

ery year the company publishes an annual summary for employees. Osvald Bjelland, a partner at the Service Management Group, an international consulting firm, calls the service tracking report "the best feedback on service quality I have ever come across."

American Express uses an awesome collection of other tools to produce top-notch service, including over 100 programs for recognizing and rewarding people who take unusual care of customers. A six-person team from headquarters makes the rounds of operating departments to check quality, and this year American Express will start following up on over 20,000 transactions with customers to see how they rate the treatment they've received. If the company's reputation starts to falter, Robinson aims to be the first to know.

Incompetent people can't render good service, so the best companies tend to recruit meticulously. Singapore Airlines and Delta Air Lines are good examples. Both have outstanding reputations for service; Delta's seems to have declined a bit but is still strong even after a horrendous string of mishaps last summer that included a near collision in the air and a near landing in the ocean. Singapore hires less than 2% of the thousands of women who want to become "Singapore girls"—yes, that's what the airline, based in a male-dominated land, calls its female flight attendants. Delta takes on even fewer, accepting merely 40 to 48 of the more than 20,000 applicants for flight attendant jobs who write in each month.

Both companies insist on months of rigorous training. Singapore's future stewardesses, many of them from humble backgrounds, learn how to use makeup and serve luxurious meals that feature items with which they are unfamiliar, like fish forks and caviar. They are cautioned not to drink alcohol or eat onions for ten hours before coming to work. They cannot even start their jobs until they have done time at behind-the-scenes tasks, like cleaning airplane cabins and accompanying the airline's salesmen on visits to travel agents. "All this is geared toward developing a well-rounded Singapore girl, one who knows all about the airline," says Michael Tan, a Singapore director. Delta does much the same, insisting that aspiring stewards and stewardesses move up through the back-office ranks before they get their wings.

FEW TRAINING PROGRAMS are as intense as the one Merck uses to turn new hires into the kind of salespeople who will uphold the drug company's No. 1 rating for service to pharmacists and doctors. Aspirants first study basic medical subjects for ten weeks—anatomy, physiology, disease—and must score 90% or better on a weekly test to stay in the program. In phase two they spend three weeks learning how to discuss and present Merck's products, then go on trial for six months, making presentations in the field along with their district managers. Phase three is another three weeks at headquarters, brushing up presentation skills. Even after more than 11 months of training, salesmen must regularly attend "primary didactics," medical classes conducted at Harvard, Johns Hopkins, and other universities. "Training is our obsession," says Jerry Keller, a vice president at Merck Sharp

WHO SERVES CUSTOMERS BEST, INDUSTRY BY INDUSTRY

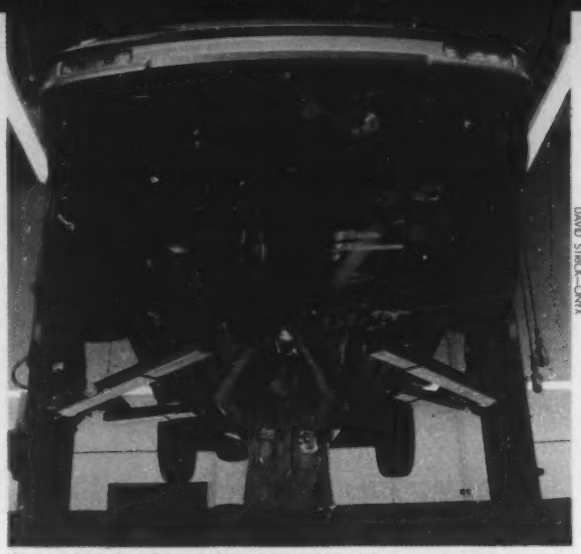
	AIRLINES (DOMESTIC)	AIRLINES (INT'L)	APPAREL MAKERS	AUTOMOBILE DEALERS	COMMERCIAL BANKS	COMPUTER MAKERS	CREDIT CARD ISSUERS
COMPANY Headquarters	**AMERICAN** Fort Worth	**SINGAPORE** Singapore	**LIZ CLAIBORNE** New York City	**ACURA** Gardena, Calif.	**J.P. MORGAN** New York City	**AMDAHL** Sunnyvale, Calif.	**AMERICAN EXPRESS** New York City
SALES in millions	**$5,857**	**$1,560**	**$813**	**N.A.**	**$76,039** (assets)	**$966**	**$5,951**
FIVE-YEAR GROWTH RATE	8%	7%	47%	N.A.	7%	17%	22%
INDUSTRY'S FIVE-YEAR GROWTH RATE	7%	6%	8%	11%	8%	23%	12%
HOW THE LEADER EXCELS	Some 30,000 frequent fliers polled by the International Foundation of Airline Passengers Association say American is tops. Former champ Delta has fallen but still draws fewest complaints per passenger as tracked by DOT.	Singapore repeatedly ranks high, rated best (with Air New Zealand) by readers of *Travel-Holiday*, second by IFAPA members. Crossing the Atlantic, take IFAPA's No. 1 choice, Swissair.	A poll of 1,000 rag trade executives by *Sales and Marketing Management* said Claiborne's salesmen are best at keeping customers. One reason: They sell retailers only what stores can sell, so markdowns are infrequent.	This first-place ranking by J.D. Power, an auto-industry researcher, is no surprise: American Honda chose most dealers for its Acura line from the top 25% of its own dealers, who as a whole place second in service, just ahead of Mercedes-Benz.	In a confidential survey last summer, financial executives at over 1,200 of the biggest U.S. companies rated Morgan highest for its prompt, efficient follow-up and innovative dealmaking. Citicorp and Chase completed the top three.	Customers surveyed by Datapro, a market researcher, rate Amdahl No. 1 in service among mainframe makers. National Advanced Systems, an arm of National Semiconductor, also looked strong.	Amex offers "positively the most prompt and courteous customer service in the world," says the *Nilson Report*, a credit card newsletter. Sales are for American Express Travel Related Services.

SOURCES OF INDUSTRY GROWTH RATES: INTERNATIONAL DATA CORP. (COMPUTER MAKERS), *NILSON REPORT* (CREDIT CARD ISSUERS), SECURITIES INDUSTRY ASSOCIATION (DISCOUNT BROKERS), PHARMACEUTICAL MANUFACTURERS

& Dohme, Merck's U.S. drug division. "People who come to us from other companies can't believe we have this kind of program."

Motivation, Keller notes, is just as important as training. "Salesmen motivate themselves because we show that we care about and respect them. A lot of places treat their salesmen like children." At Merck no salesman will be chastised for taking off at 4 P.M. to see a ball game with his family; in return, salesmen give their home numbers to physicians and stand ready 24 hours a day to answer questions or fill emergency orders. "We let them decide how to spend their time," says Keller, "and they pay us back in abundance. I don't think the money motivates them at all."

Keller's loose-reined approach is typical among companies that serve their customers well. Managers in lesser companies, driven by the desire to make service and sales people more productive, usually turn up the pressure, clocking how long it takes a telephone operator to handle a customer's complaint, insisting on elaborate reports from field salesmen. Striving to control the uncontrollable, they mechanize customer service as much as possible. That's exactly the wrong way to do it, says Richard Whiteley, a principal at Forum Corp., which specializes in sales and service training. He explains: "Successful service organizations empower individuals to offer the best possible service they can, within reasonable limits."



DAVID STRICK—ONYX

Checking for flaws, *a dealer's technician grooms this brand-new Acura Legend coupe for delivery to a California customer.*

At Marriott and other companies known for good service, the people who render it are called associates and colleagues rather than customer service reps. They are remarkably free to call on every part of the company in helping customers, and they earn lush bonuses for extraordinary work. American Express thrives on heroic stories of how its people rescue customers from civil war and natural disasters, even when that means convulsing the company and spending thousands of dollars. Cash awards of up to $1,000 go to certified Great Performers such as Barbara Weber, 37, who last year cut through miles of State Department and Treasury Department red tape to refund $980 of stolen traveler's checks to a customer stranded in Cuba.

Training and motivating is especially tough in industries that pay the minimum wage, like supermarkets and hotels. They generally can't afford to be picky about hiring and so end up with the rawest of recruits, nearly all

DISCOUNT BROKERS	DRUG MAKERS	FEDERAL AGENCIES	FROZEN FOOD PRODUCERS	HOTEL CHAINS	MAIL ORDER MERCHANTS	NUTS & BOLTS DISTRIBUTORS	SUPERMARKET CHAINS
FIDELITY Boston	**MERCK** Rahway, N.J.	**FCC, SEC, U.S. POSTAL SVCE.** Washington	**CAMPBELL SOUP** Camden, N.J.	**EMBASSY SUITES** Irving, Texas	**L.L. BEAN** Freeport, Maine	**SERVICE SUPPLY** Indianapolis	**WEGMANS** Rochester, N.Y.
$100 (est.)	**$4,128**	**$3,100**	**$1,250**	**$349**	**$369**	**$55**	**$850**
42%	7%	10%	14%	N.A.	16%	(1%)	16%
25%	14%	N.A.	4%	7%	9%	N.A.	5%
Surveys by Payment Systems Inc. of Tampa show consumers rank Fidelity Investor Centers highest.	According to *Sales and Marketing Management*, drug industry executives give Merck the nod for its salesmens' technical knowledge, training, and reputation among customers.	This may surprise many postal customers, but these three agencies are best at handling complaints from consumers, says Technical Assistance Research Programs Institute of Washington, D.C. Figures are for U.S. Postal Service.	Grocery buyers and distributors say Campbell gives the best service in frozen foods, according to Meyers Research Center of New York. Kellogg is tops in dry groceries, Kraft in refrigerated foods.	After 232,000 visits to all major chains, readers of *Consumer Reports* rated Embassy tops in the mid- and high-price categories. Stouffer, Marriott, and Westin also ranked high for their helpful, efficient staffs.	From underwear to luggage, say 165,000 readers of *Consumer Reports*, Bean is best; Lands' End ties for first in many categories. Other winners: J.C. Penney (kitchenware), Brookstone (gadgets), Omaha Steaks (food).	Eleven relatives of founder Edgar Seitz run what they call the "house of a million screws." Readers of *Industrial Distribution* rated it best. Sales have shrunk because the company has sold operations.	Wegmans ranks just ahead of Publix (Florida) and Fred Meyer (Northwest), says the Consumer Network, a national panel of shoppers. Other outstanding chains like J. Bildner & Sons (Boston) and Byerly's (Minneapolis) weren't rated.

ASSOCIATION (DRUG MAKERS); LAVENTHOL & HORWATH (HOTEL CHAINS); MAXWELL SROG PUBLISHERS (MAIL ORDER MERCHANTS); *PROGRESSIVE GROCER* (SUPERMARKET CHAINS).

eager to leave for better jobs. The dilemma doesn't bother Danny Wegman, president of Wegmans Food Markets, a 38-store chain based in Rochester, New York. An effective solution, he finds, is liberal college scholarships. After working at Wegmans for a year, any employee who performs well, can write a convincing application, and seems likely to do well in college or graduate school can get a scholarship for half his tuition. So far almost 1,000 of Wegmans' 11,000 full- and part-time employees have made the grade, staying in school—and at Wegmans. Those motivated workers give the best service in the industry, according to the Consumer Network of Philadelphia, a nationwide group of 3,500 shoppers. One of them says: "I've lived in Japan, and service at Wegmans is just like service in Japan. It's what a supermarket ought to be."

GEORGE STEWART

Flipped-to-order *breakfasts are free at Embassy Suites Hotels, and so is a daily cocktail party.*

Now Danny Wegman has extended the work-study program to high school students who seem likely to drop out. Last May he invited borderline cases from the Rochester public schools to join Wegmans Work-Scholarship Connection, which offers $5,000 college scholarships to students who keep working at Wegmans and attending high school. "Five months later," Wegman says, "the 30 we hired are all still here. We've never had that kind of retention rate."

The prize for managing low-paid service workers may belong to Embassy Suites Hotels, a subsidiary of Holiday Corp. that specializes in hotels made up solely of suites. "Historically hotel managers have believed that minimum-wage workers aren't smart or ambitious," says Hervey Feldman, president of Embassy Suites. "That's just not true. With training and experience, they all have the curiosity and intelligence to go beyond making beds." To ensure that he hires and promotes general managers who share his views, Feldman looks most closely at candidates' interpersonal skills, especially their inclination to treat all people as if they are competent. To help motivate workers, managers post in the employee lounge a daily report on the hotel's occupancy rate, average room rate, and estimated profits, along with comments from at least five customers interviewed at random the day before. If the hotel is achieving its goals, even the lowest-paid worker can receive a monthly bonus of over $100.

"Minimum-wage workers are going to get out of that pit as fast as they possibly can," Feldman says. To keep them moving up in the fast-growing chain, and not out, he has cooked up a pay system based on skills. A housekeeper who wants to run, say, the front desk can take company-sponsored classes in that skill. Passing grades don't mean an immediate promotion, but they're worth an extra 25 cents an hour or so in housekeeping wages, as well as the chance to fill in at the front desk when demand peaks. "I don't know of any other hotel that builds in switch-hitters like we do," Feldman boasts. About a quarter of Embassy's 4,500 hourly workers are usually in the training program, which has produced two dozen managers and assistant managers so far.

Customers all want effective service that solves problems quickly, but surveys show that the emotional tone of the person serving them makes just as strong an impression. So companies desperate to improve service often try to get by with a quick tuneup of front-line employees' attitudes. Those tactics usually don't work. In a survey of 212 companies, the Zenger-Miller consulting firm of Cupertino, California, found that programs to improve service frequently boil down to teaching employees the soft sell, pumping them up with motivational seminars, and training them in telephone and courtesy skills—"smile-and-dial," as they say in the training game. "Front-line workers don't create service quality," says Roland Dumas, a research manager at the firm. "They just deliver it. Expecting training alone to improve service quality is like making a loading-dock worker responsible for the quality of products."

FOR A COMPANY to shine in customer service, every manager and employee has to get the service religion. One practical way to shape their behavior: Get back-office departments to treat front-line operations as customers. When product designers have to sell their ideas to salesmen, for example, the whole organization tends to become more sensitive and responsive to the ultimate, outside customer.

That's what has happened at Campbell Soup, whose frozen-food operation gets top marks for service to retailers. Carl Stinnett, a vice president, left Nestlé for Campbell two years ago. "I'm impressed with the breadth of concern for customer service here," he says. "You obviously hear it in sales, but you also hear it in marketing, in the plants, and even in finance." To keep plant managers from dismissing customer requests as annoying interruptions, Campbell assigns a salesman full-time to each of its ten plants that make direct shipments. His job is to ensure that grocers get the products they want when they want them, even if that means disrupting production to load, ship, and bill an emergency order in one day. "Most companies have a transportation or warehousing type to handle this function," observes Michael Newland, another Campbell vice president. "But we find that keeping a salesman at the plant makes everybody there respond better to customers."

continued

The company doesn't consider even that safeguard sufficient. Fearing that its in-plant salesmen might be overlooking something, Campbell is sending experienced manufacturing people into the field to act as ombudsmen for customers. These roving inspectors visit customers to discover new ways of improving service, such as changing the way cases of Swanson frozen dinners are loaded in order to cut down on damage.

Many companies will never provide outstanding service because they are afraid to spend the bundle it costs. Maintaining lavish inventories or excess production capacity is virtually mandatory. Example: Service Supply Corp. of Indianapolis, which styles itself the "House of a Million Screws." It stocks over 74,000 fasteners, from nearly invisible screws for eyeglasses to yard-long structural bolts for bridges to the patented Mac Lean-Fogg Whiz-Lock, a self-locking screw that is nearly impossible to remove. Mel Seitz Jr., Service Supply's president, claims he can immediately ship 95 of any 100 items a customer is likely to order, compared with an average of 55 items for other nuts-and-bolts distributors. Carrying all that inventory makes Service Supply slightly less profitable than its competitors, Seitz says, but faster growing: "The return on our inventory investment is seen in our reputation, which increases business and will eventually increase profit margins."

continued

SERVICE STARTS WITH THE MAN AT THE TOP

MARK SELIGER

Hervey Feldman of Embassy Suites

■ The most important factor in outstanding customer service sits in the corner office. When the CEO eats, sleeps, and breathes service, the rest of the troops catch the spirit pretty quick.

Leon Gorman, president of L.L. Bean, measures his company's order fulfillment in half-days. Mel Seitz Jr., president of Service Supply Corp., returned home one night to find a message from a customer who needed some two-inch nuts, but when Seitz called back it was too late; the customer had called Seitz's father, Service Supply's retired chairman, and he had taken care of the matter. David Cariseo, president of Fidelity Investor Centers, is impatient with anything less than perfection: "My attitude is, if you could put Frank Borman on the moon and bring him back alive, we ought to be able to solve any customer's problems."

Two other chiefs have shown how widely differing styles can pay off equally well. American Express's James D. Robinson III is a hands-off manager. Hervey Feldman of Embassy Suites Hotels is hands-on. Both are service champs.

Robinson, 52, is a master of using service to give a marketing edge to his products, whether they are credit cards or a bank. "In a commodity-like business, service is the only way to create product differentiation," he explains. Robinson gives senior executives an unusual degree of autonomy, interfering only rarely and doing so with an almost imperceptible touch. But he gets his message across by repeating it—incessantly and generally without fireworks. "The constancy of the message is what's important," says Robinson. After years of being hammered in, it has become part of the company culture.

Feldman, 50, didn't create the all-suite hotel, but he honed what once was a faddish concept into the hottest lodging design of the decade. Embassy Suites earns a gross profit margin of 50%, 20 points higher than the margins achieved by such competitors as Hilton, Sheraton, and Westin. Feldman is mindful of the irritation so many business travelers feel from their contacts with the travel industry, and frequently travels to check out his own hotels. He also visits those of competitors and is occasionally disappointed: "I'm a very bad customer, always looking at the jobs people do and the way they do them."

For an admittedly tough customer, Feldman's requirements seem reasonable enough. Just give him a hassle-free and friendly experience. Among the hotel chains he scouts, he gives highest marks to the Four Seasons chain (the Ritz Carlton in Chicago, the Pierre in New York), at least in the luxury category.

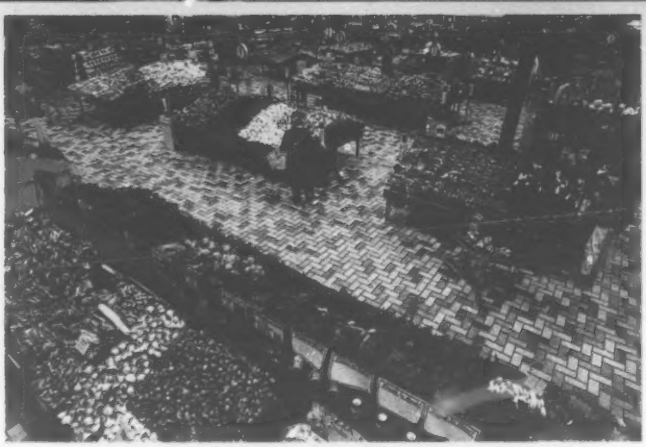
Off the job, both men seem able to take their minds away from their business obsession. Wall Streeters speculate that Robinson is gearing up for a Cabinet post, and he has said that by 1990 or so he may be ready to let someone else run American Express. He says he has "absolutely no" political ambitions. As for Feldman's private life, having him as a husband or father sounds a bit unsettling ("That's not a properly made bed, young man"; "Honey, how *could* you serve from the right?"). But Feldman insists that he does not make his wife, Ellen, and 3-year-old son get out of their rooms by 11 A.M. Says he: "At home I'm a little more forgiving."

—Bill Saporito and Monci Jo Williams

James D. Robinson III of American Express

GEORGE LANGE

JAN STALLER (2)



"Wonder store" *is one shopper's name for Wegmans. Thanks to the palatial size of its new supermarkets—around 90,000 square feet—the chain can offer mind-boggling variety, uncrowded browsing, and swift checkouts.*

Scrimping on capacity is a terrific way to infuriate customers, as investors who tried to call their brokers on Black Monday can confirm. Fidelity Investor Centers claims to get an edge on other discount brokers by employing more telephone operators per customer. During Black Monday, Fidelity more than tripled its staff of operators from 250 to about 800. Some customers couldn't get through for an hour, and 3% of Fidelity's 580,000 callers gave up, but the company answered its phones within 48 seconds on average. Some lesser firms reportedly dealt with the massacre by leaving their phones off the hook.

New technology is an important part of the high cost of great service. Wegmans started installing optical scanners to speed up supermarket checkouts back in 1974, years before scanners swept the industry; it began installing automated teller machines tied into local banks back in 1983. Campbell was among the first food producers to equip salesmen with powerful hand-held computers. This year American Express's Travel Related Services Co., which deals in charge cards and traveler's checks, plans to spend some $300 million on technology, including exotic artificial intelligence programs that most companies think are too advanced to be useful.

A powerful motive for this technomania is efficiency. Providing customer service, after all, means hiring lots of people, and technology is the best hope for improving their productivity. But companies that understand service don't use technology mainly to get more work out of their employees, as a factory might. They say the biggest benefits come from improving the quality of service and offering new services.

The Authorizer's Assistant, for instance, one of American Express's artificial intelligence programs, helps credit authorizers decide whether to approve a cardholder's purchase (FORTUNE, October 12). American Express doesn't measure the benefits in approvals per hour. Instead it measures the payoff from making better judgments. The company estimates it will save seven times more than it would from productivity improvements alone because fewer bad credit risks will get by and fewer good ones will be turned down.

WITH ALL THIS spending, how do the leaders in service achieve better financial results than their competitors, as the PIMS study says they do? Answer: Customers will pay more for superior service. The key is finding a service strategy—knowing exactly which group of customers you want to serve and figuring out what kind of service will loosen their purse strings. "Because the investment is so substantial, most companies can't invest in customer service across the board," observes Booz Allen & Hamilton consultant Randy Myer. "More and more we're helping them work out what their customer service strategy ought to be."

The strategy must be tightly focused. Jan Carlzon, Sweden's answer to Lee Iacocca, swung Scandinavian Airlines System from steady losses to steady profits in only two years by concentrating narrowly on business travelers. He laid on frequent early morning and early evening flights, installed movable partitions in aircraft cabins so SAS could expand business-class sections at will, and coached his staff to handle business travelers like royalty. None of those moves appealed to tourists looking for bargains, but the customers Carlzon really wanted often made SAS their first choice in his part of the world. People Express, by contrast, foundered when it tried to capture two widely differing market segments with essentially the same service. The airline's famous No Frills strategy was just the ticket for budget travelers, and operating revenues soared from $139 million in 1982 to $978 million in

1985. But when People Express later tried to fill its ever-growing fleet with business travelers, they said no to No Frills. Losing focus drove People into the clutches of Texas Air late last year.

The best way to develop a service strategy is to listen to customers. They're quite willing to say what kind of service they want and to rate the service they're getting. But most companies have cotton in their ears. They rely heavily on complaints that come in over toll-free telephone lines and on comment cards, those ubiquitous service questionnaires that hotels and airlines hand out. "The problem with such methods is that they measure only the extremes," says Christopher Hart, an assistant professor at Harvard Business School who studies service industries. "You hear from Mr. Grumpy and Mr. Smiley, but not from Mr. Average."

Outstanding service companies use toll-free lines and comment cards only to supplement their incessant customer surveys. Embassy Suites recently augmented the roughly 350 free-form customer interviews it conducts every day with a survey of 6,000 guests. "It's probably the most extensive survey ever in the hotel industry," claims Feldman, the chain's president. (The biggest complaint: 18% said the chain should improve its free breakfasts.) Every week Fidelity Investor Centers asks 3,000 customers who have recently executed trades to rate the service they received and suggest improvements. The reason, according to David Cariseo, the brokerage's president: "We're a luxury item. People could spend their whole lives without investing with us. So we have to provide luxury service."

Cadillac gathers focus groups of owners and monitors very repair order and complaint registered by its 25 "listening post" dealers. The company has discovered that customers are most upset with the dealers' inability to repair cars right the first time. "That's not easy to fix," says John Grettenberger, Cadillac's general manager, "because luxury cars have so much complex equipment." Grettenberger set up a system that links every dealer with a corps of ten engineers who use computerized caches of engineering drawings and service bulletins to walk dealers through repairs that stump them. While over 40% of repairs by all automobile dealers have to be redone, says Cadillac, its own dealers have lowered their proportion to 35% and are still pushing. This year Cadillac jumped from 14th to seventh place in the rankings of service compiled by J.D. Power & Associates, an automobile industry research company.

IMPROVING SERVICE is about as difficult a job as a company can undertake, because it means reforming attitudes and practices in nearly every department. Strong cultures and close ties to their customers seem to make the job easier for smaller, family-owned firms, but bigger, more bureaucratic companies can have a terrible time. "They haven't worked out the methods for ensuring service quality," says Roland Dumas of Zenger-Miller. "In most service organizations, I can be applauded as a genius simply by walking in and applying the statistical process controls that manufacturers have used for years."

Providing superior service need not be a touchy-feely mystery. It requires hardheaded analysis, talented management of people, intense concentration and commitment, and serious spending, but not black magic. American managers have learned to improve the quality of their products enormously in recent years. The champions of customer pampering show that organizations can improve service with similar common-sense management tools. ■

COMPANIES THAT SERVE YOU WORST

■ Everyone has a special horror story about customer service. The most infuriating these days probably concern air travel. Runaway traffic growth and many carriers' difficulty in adapting to mergers are major reasons passenger complaints have nearly quadrupled since last year. Now bad service has become a federal case: Both houses of Congress have passed bills that require airlines to post their on-time and lost-baggage records for all to see.

The worst offender is Texas Air, the union-busting holding company that absorbed Continental, Eastern, and People Express. Continental led the industry in complaints per 100,000 passengers for the first nine months of 1987. But it isn't always the worst. In September only two-thirds of USAir's flights arrived on time, the sorriest showing by any major domestic airline, and Pan Am got the booby prize for the highest percentage of passengers bumped and highest percentage of flights that usually arrive more than 15 minutes late.

Bigness, conglomeration, and lack of competition often lead to poor service. Beatrice, a giant in packaged foods, went private last year and is in the throes of dissolution. It gets the lowest ratings for service to food retailers and distributors. After visiting relatively high-priced national hotel chains, readers of *Consumer Reports* criticized Hilton and Sheraton, ITT's giant hotel subsidiary. Consumer satisfaction with cable TV operators, which are monopolies in most areas, has been declining ever since the Yankelovich Monitor started measuring it in 1984.

Smallness and competition, however, don't guarantee caring service. Independent auto repair shops and home repair and maintenance companies tend to be modest neighborhood enterprises, but polls say they offer abysmal service. For service so awful that it verges on fraud, try the sleazier mail-order merchants, especially some of those that offer exotic clothing, imitations of famous perfumes, and cheap plants, bulbs, and seeds for the garden.

To the detriment of some companies, reputation can belie reality. Customers tend to recall bad experiences more vividly than good ones. Several studies have indicated that a customer will tell only a handful of friends about the great service he has received, but will singe the ears of as many as 20 people with tales of shabby treatment. They in turn tell their friends, and word of mouth soon blackens the reputation of the offending company, even if its general level of service is top-notch. No wonder Jan Carlzon of Scandinavian Airlines System says that every year his employees' contacts with customers create "50 million moments of truth."

If the difficulties of giving good service seem daunting, consider the far higher cost of polishing a tarnished reputation. Continental Airlines is spending millions this year to advertise its rededication to service, and some $60 million on training employees to be more courteous and efficient. Even so, Continental cannot expect to recoup its investment quickly. Today's horror stories will take years to die.